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SUBJECT: High Food Inflation Eclipses Economic Recovery

REF: NEW DELHI 02482

11. SUMMARY: Despite a promising overall economic outlook, rising food price inflation continues to pose a serious challenge to the Government of India (GOI). Food prices increased by a staggering 19.95 percent for the week ending on December 5, the fastest pace in eleven years. Causes of the rising food prices include both supply and demand factors. Uneven distribution of monsoon rains this summer resulted in a decline in production of India's fall and early winter-harvested (kharif) crops, while India's overall economic growth has driven up purchasing power, particularly in the rural sector. Increased government procurement of essential commodities and high government support prices has also played a role in rising food inflation. The GOI has taken various measures meant to contain food prices, including abolishing import duties for essential food items such as rice, wheat, pulses, sugar, and vegetable oils; imposing stocks and licensing restrictions on private trade of essential commodities and banning futures trading. Nevertheless, analysts predict that some of these measures will likely backfire rather than help. Extensive restriction on private trade could also negatively impact private investment in agriculture, further slowing agricultural growth. In Parliament, the opposition has taken up the offensive, criticizing the Congress-led United Progressive Alliance (UPA) for allowing food prices to rise. Because food price inflation is always a potentially explosive political issue in the Indian context, further political fallout can be expected if food prices are not contained. End Summary.

Economic Growth Accelerates
in the Second Quarter ...

12. Buoyed by manufacturing and services sectors, India's gross domestic product (GDP) registered 7.9 percent growth during the second quarter of Indian Fiscal Year (IFY) 2009/10 (Apr-Mar), well above forecasts made by most government agencies and non-government entities (see reftel). This rate compares with 6.1 percent growth in the first quarter and 7.7 percent during the corresponding quarter of the previous fiscal year. The surge in GDP growth was fueled by private consumption growth, supported by government stimulus packages and an increase in government stimulus expenditures. The higher than expected second-quarter growth in GDP has prompted many experts of the Indian economy to revise the country's economic growth forecast upward to seven percent or above in IFY 2009/10 from the earlier forecast of around 6.5 percent. IFY 2008/09 GDP growth rate reached only 6.7 percent, significantly down from the average nine percent growth registered during the previous three years due to the global financial crisis.

13. Agricultural GDP growth in the second quarter of IFY 2009/10, however, was a modest 0.9 percent compared with 2.4 percent in the first quarter and 2.7 percent during the corresponding quarter of IFY 2008/09. There are further apprehensions about third-quarter

agricultural GDP growth due to the negative impact of the drought on agricultural production during the fall and early winter harvest season, which could pull down overall economic growth. Many economists argue that since the contribution of the agriculture sector to the country's GDP has now declined to 17 percent, overall GDP growth is decoupling from agriculture.

... As GOI Continues Fighting
High Food Price Inflation

¶4. Despite the promising economic growth outlook, containing rising food inflation continues to pose a serious challenge to the GOI. Although India's headline wholesale price index-based inflation rose more than expected by 4.78 percent YOY in November 09 from 1.34 percent in October 09 (since peaking at around 13 percent in early August 2008), food price inflation continues to gallop, reaching 19.95 percent for the week ending December 5, far exceeding the previous peak reached following the global commodity boom in 2008. This food price figure is based on an index of food articles compiled by the Ministry of Commerce.

¶5. According to experts, the wholesale price index-based inflation does not capture the full impact of the rise of food prices as the food group weight in the index is only around 15 percent. A more accurate indicator of the effect that food price inflation is having on consumers would be the various consumer price indices (CPI), which are more heavily weighted toward food than the wholesale price index. As of October, the three CPIs reported inflation ranging from 12 to 14 percent, indicating how high food prices have eroded the average consumer's purchasing power, posing a further challenge to GOI efforts to address food and nutrition security.

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¶6. On December 16, the opposition took up the issue of food inflation in Parliament, forcing a shutdown of the lower house (Lok Sabha) as opposition members accused the government of not taking action to counter sky-rocketing food prices. Local media reports that opposition leaders claimed they would "take the issue to the streets" if the GOI does not change policy. Trade unions, including one Congress trade union, protested the rising food prices outside the Parliament. On December 17, a panel of Indian MPs presented a report criticizing the government for failing to intervene, demanding an investigation into surging sugar prices and new mechanisms to provide basic food items directly to low-income consumers.

¶7. With food price inflation discussions taking on heightened significance during the ongoing winter session of the Parliament, the GOI is in emergency mode trying to tackle the situation through imports and more restrictions on private trade. One victim of the current high food inflation is the Congress-led government's election promise of enacting an ambitious Food Security Act, which seeks to supply 25 kg of wheat or rice per month to below poverty line (BPL) families at a highly subsidized rate of Rs. 3 (U.S. 6 cents) per kg. Implementation of the provisions of this legislation was already posing a challenge to the GOI due to ambiguity regarding the number of BPL families, the problem in delivering the grain to targeted families, and the additional government subsidy involved. Food price inflation, along with these overall implementation problems, has forced the GOI to stall enactment of the Food Security Act, if not completely abandon it.

Causes: Supply-Side Problems

¶8. Several factors, mostly supply-driven and some policy-related, have contributed to the current spurt in food prices. An uneven distribution of monsoon rains this summer resulted in decreased harvests of fall and early winter crops, particularly rice and coarse cereals, which increased prices. The poor monsoon and pest disease problems in some crops such as potatoes also resulted in a decline in production of vegetables, fruits and pulses, further contributing to food inflationary pressure. Lack of a consolidated cold chain also results regularly in large losses in perishable food

items in high summer temperatures and discourages large-scale imports. Following a significant cyclical downturn in sugarcane production last year and this year, sugar production has plummeted and prices have skyrocketed. Drought conditions resulting in reduced fodder availability, combined with high prices of feed grain and oil meals, have led to high domestic prices of milk, poultry, and meat products. Major organized milk vendors such as Amul and Mother Dairy have raised their retail prices of milk and milk products several times in the past few months. Prices of tea, coffee, condiments and spices have also moved up steadily over recent years due to production declines, combined with increasing demand. The only food item price that has not gone up in the past year is vegetable oils, due to large-scale imports of lower-priced vegetable oils at zero import duty.

Causes: High Support Prices and
Larger Government Procurement

¶9. High support prices and increased government procurement have contributed to current food price inflation as well. Although rice and wheat production have shown a steady increase over the past decade, reaching record levels of 99.2 million tons and 80.6 million tons respectively in the 2008/09 marketing year, such increases in production were achieved by offering high minimum support prices (MSP) to farmers. Over the past five years, the wheat MSP has increased approximately 70 percent to the current Rs. 10,800 (USD 232) per ton. For Marketing Year (MY) 2011, which is from March to April 2010/11, the GOI has announced a support price of Rs. 11,000 (USD 236.5) per ton. MSP for paddy (rice) increased over 70 percent to Rs. 10,300 (USD 221) per ton for superior grades, thus establishing high market-clearing prices. There have also been significant increases in the support price for other commodities such as oilseeds, pulses, and coarse grains.

¶10. By offering high prices in 2009, the GOI has procured a major share of India's wheat and rice production, resulting in smaller open-market availability for these grains, further contributing to high market prices. Paradoxically, the GOI is sitting on the highest level of wheat and rice stocks since 2002. Over the past 18 months the GOI became the major buyer of wheat and rice in India by offering very high support prices to farmers, discouraging private participation in grain trade by imposing stocks restrictions and

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banning exports. To illustrate, GOI wheat stocks are close to the combined wheat crops of Australia and Argentina at 28.5 million tons, and rice stocks far exceed the combined rice stocks of all major rice exporting countries at 15.3 million tons as of October 1, ¶2009. Despite this, the GOI has been reluctant to sell surplus at below-market prices in the open market to help ease food price inflation.

Causes: Increased Demand

¶11. Strong economic growth in recent years, notwithstanding a slowdown last year due to the global economic crisis, has resulted in increasing purchasing power in the economy. The rise in consumer demand for high-value food products such as milk, meat, fruits and vegetables is also contributing to the increase in prices of these commodities. The GOI's flagship National Rural Employment Guarantee Act (NREGA), which provides assured employment to one member of the family for at 100 days a year at a minimum daily wage of Rs. 100, has led to increased purchasing power. Finally, the easy credit policy and release of overdue pay to government employees has also contributed to increased purchasing power in both rural and urban areas. This increase in purchasing power has led to higher demand for food products, pushing up prices for food.

Food Price Inflation and Trade

¶12. Despite the sharp decline in fall and early-winter rice production this year due to the delayed monsoon, near-record government wheat and rice stocks should allow the GOI to make it

through the crisis without imports. To rein in the rising prices of rice and wheat, the GOI has decided to sell both these commodities in the open market at the GOI's support price, which is higher than prevailing market prices. This has in fact contributed to the food price inflation. Hence, the GOI is now considering selling wheat and rice at lower prices. In order to conserve grain stocks, the GOI has decided not to permit exports of wheat and non-basmati rice in the foreseeable future, even on a government-to-government basis as food aid. Although the GOI has permitted imports of rice at zero import duty, no imports have taken place because the international prices of rice are even higher than the domestic price. In the case of wheat, despite zero import duty and lower international prices, the GOI's overly-stringent phytosanitary norms make large-scale imports difficult. However, some private millers in south India have started importing small quantities of wheat in containers.

¶13. The GOI does not maintain buffer stocks of pulses, thus large imports of pulses at zero duty will continue. According to analysts, the GOI is likely to continue and even increase the subsidy provided to public sector trading companies for imports of pulses to offset any losses. The GOI has decided to continue the zero import duty on crude vegetable oil imports and the low (7.5 percent) duty on refined vegetable oil imports indefinitely in order to contain any potential increase in prices of vegetable oils following a poor harvest. Zero duty imports of sugar will continue in MY 2009/10 to contain the rising prices of sugar. There is little the GOI can do to contain rising prices of vegetables and fruits due to supply side constraints. However, a duty reduction on vegetable and fruit imports, which are currently subject to more than a 30 percent import duty, would possibly encourage increased imports and expand free market supplies.

WHAT NEXT? GOI'S NEXT STEPS

¶14. Because the current food price inflation is largely supply-driven, the government is making an all out effort to increase agricultural production in the winter (rabi) season by providing various input subsidies and soft credit support to farmers. As hoarding (large scale speculative stock holding of commodities) and black marketing by private traders are considered to be some of the reasons for high domestic food prices, the GOI has encouraged state governments to impose stocks limits and price controls on private trade dealing in rice, paddy, pulses, sugar, edible oils, and oilseeds under the Essential Commodities Act. Accordingly, many states have imposed such restrictions.

¶15. COMMENT: With most of the food inflation supply-side driven, there are no easy or quick fixes for the GOI to reign in rising food prices. The GOI is likely to try measures such as continuing the ban on futures trading of agriculture products, placing further limits on private trade, making efforts to increase rice production, or tightening monetary measures. However, as with most GOI efforts to date to manage the agriculture sector, many of these measures

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will likely backfire. Instead of helping to control the food price inflation, the measures will reduce open market availability, resulting in higher open-market prices, slowing of agriculture growth and slowing of growth in the overall economy. Because food price inflation is a volatile political issue in the Indian context, a significant increase in attention and continued criticism of the UPA-led government from the opposition can be expected if food prices are not contained. END COMMENT.

ROEMER